BEFORE THE
ILLINOIS COMMERCE COMMISSION

In the Matter of	)	
Global Time, Inc.	)	
	)	Docket No.: **00-0193**
Application For a Certificate to Become a Telecommunications Carrier	)	

PRE-FILED TESTIMONY OF ANN YANICK
ON BEHALF OF
GLOBAL TIME, INC.

322964.1

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND TELEPHONE NUMBER.

A. My name is Ann Yanick. My business address is Global Time, Inc. ("Global Time"), 500 Airport Boulevard, Suite 340, Burlingame, California 94010. My business telephone number is (650) 375-6700.

Q. WHAT IS YOUR POSITION WITH GLOBAL TIME?

A. I am Global Time's Director of Operations and Customer Service.

Q. WHAT ARE YOUR RESPONSIBILITIES AS DIRECTOR?

A. I am currently responsible for the operations, customer services and marketing of the company.

Q. PLEASE BRIEFLY DESCRIBE YOUR PREVIOUS PROFESSIONAL EXPERIENCE AND QUALIFICATIONS.

A. Prior to joining Pacific Gateway Exchange, Inc., the parent company of Global Time, in 1997 and Global Time in 1998, I had twelve years of telecommunications experience with AT & T. During the twelve years, my responsibilities ranged from customer service and inquiries to operations and products management, mostly in the international arena. From 1989-1992, I studied international business at the University of Colorado.

Q. HAVE YOU TESTIFIED BEFORE THE ILLINOIS COMMERCE COMMISSION ("COMMISSION") PREVIOUSLY?

A. No.

Q. IS GLOBAL TIME CURRENTLY CERTIFICATED TO PROVIDE SERVICE IN ILLINOIS?

A. No.

Q. IS GLOBAL TIME LEGALLY AUTHORIZED TO DO BUSINESS IN ILLINOIS?

A. Yes. A copy of Global Time's Certificate of Authority to Transact Business in the State of Illinois was submitted to the Commission as Exhibit 2 of its Application.

Q. ARE YOU FAMILIAR WITH THE APPLICATION THAT WAS SUBMITTED BY GLOBAL TIME ON FEBRUARY 28, 2000 TO THE COMMISSION FOR A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY TO PROVIDE COMPETITIVE TELECOMMUNICATIONS SERVICES WITHIN THE STATE OF ILLINOIS ("APPLICATION") ?

A. Yes, I am.

Q. DO YOU HAVE ANY CHANGES OR UPDATED INFORMATION TO PROVIDE REGARDING THE APPLICATION?

A. Yes. The application listed the states in which Global Time is authorized to provide telecommunications service. Since filing the application, Global Time has become authorized to provide resold interexchange telecommunications services in the State of Oklahoma.

Q. ARE THERE ANY OTHER CHANGES OF WHICH THE COMMISSION SHOULD BE AWARE?

A. No.

Q. APART FROM THE UPDATED INFORMATION THAT YOU JUST PROVIDED, DO YOU RATIFY AND CONFIRM THE STATEMENTS THAT ARE MADE IN GLOBAL TIME'S APPLICATION?

A. Yes, I do.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to describe Global Time and the services it proposes to offer in Illinois. In addition, I will demonstrate that Global Time possesses the financial, technical, managerial and operational capabilities to operate as a provider of competitive resold interexchange service in Illinois.

Q. PLEASE DESCRIBE THE AUTHORITY THAT GLOBAL TIME SEEKS BY ITS APPLICATION.

A. Global Time seeks authority to provide competitive resold interexchange services in Illinois.

Q. PLEASE DESCRIBE THE CORPORATE STRUCTURE OF GLOBAL TIME.

A. Global Time is a corporation organized under the laws of the State of Delaware. Global Time was formed to provide interstate and intrastate telecommunications services. Global Time is a direct wholly owned subsidiary of International Exchange Communications, Inc. ("IE Com"), which in turn, is wholly owned by Pacific Gateway Exchange, Inc., ("PGE"), a publicly traded Delaware corporation.

Q. PLEASE DESCRIBE THE TYPES OF SERVICES THAT GLOBAL TIME PLANS TO OFFER IN ILLINOIS.

A. Global Time intends to offer resold intrastate interexchange telecommunications services via prepaid calling cards. Global Time's services are available on a full-time basis, 24 hours a day, seven days a week.

Q. DOES GLOBAL TIME PROPOSE TO OFFER OPERATOR SERVICES?

A. No.

Q. PLEASE DESCRIBE GLOBAL TIME'S PROPOSED MARKETING PLAN, AND HOW IT WILL PREVENT SLAMMING COMPLAINTS.

A. Global Time does not market to end users. Global Time markets its products to distributors through trade shows. Global Time's prepaid card service is also described in its web page. Global Time only intends to provide prepaid calling cards and therefore will not offer services that require the customer to presubscribe to its services. Since Global Time will initially be offering only prepaid calling card services, slamming prevention measures are not applicable at this time. To the extent that Global Time expands its service offerings in the future, Global Time will comply with Illinois requirements for verifying changes in a customer's primary interexchange carrier.

Q. PLEASE ADDRESS GLOBAL TIME'S MANAGERIAL AND TECHNICAL QUALIFICATIONS.

A. Global Time's officers have extensive managerial, financial and technical telecommunications experience and, therefore, are well qualified to execute its business plan. Descriptions of the telecommunications and managerial experience of Global Time's key personnel were attached as Exhibit 3 to Global Time's Application. These descriptions demonstrate that Global Time's personnel have a broad range of experience in successfully managing and operating telecommunications carriers. Moreover, Global Time will rely on the existing managerial and technical resources of its parent company, IE Com, and its ultimate parent company, PGE, to provide intrastate interexchange service. Accordingly, Global Time has the technical and managerial resources necessary to provide customers in the State of Illinois with high-quality, dependable, competitive intrastate interexchange telecommunications services.

Q. PLEASE DESCRIBE GLOBAL TIME'S FINANCIAL QUALIFICATIONS.

A. Global Time is financially qualified to provide resold intrastate interexchange telecommunications services in the State of Illinois. Global Time has access to the capital necessary to fulfill any obligations it may undertake with respect to the provision of telecommunications services in the State of Illinois. Copies of Global Time's financial statements as of June 30, 1999 were attached as Exhibit 4 to its Application. Moreover, Global Time will rely on the financial resources of its ultimate parent company, PGE. The audited consolidated financial statements of PGE and its subsidiaries, are submitted hereto as Exhibit A. These exhibits clearly demonstrate Global Time's financial capacity. No circumstances have changed since the filing of the Application that would call into question Global Time's or PGE's financial qualifications to provide the proposed services.

Q. HAS ANY STATE EVER DENIED GLOBAL TIME AUTHORIZATION TO PROVIDE INTRASTATE SERVICE?

A. No.

Q. HAS ANY STATE EVER REVOKED GLOBAL TIME'S CERTIFICATION?

A. No.

Q. HAS THE COMPANY EVER BEEN INVESTIGATED OR SANCTIONED BY ANY REGULATORY AUTHORITY FOR SERVICE OR BILLING IRREGULARITIES?

A. No.

Q. PLEASE DESCRIBE THE PUBLIC INTEREST BENEFITS ASSOCIATED WITH GLOBAL TIME'S PROPOSED OFFERINGS OF INTRASTATE TELECOMMUNICATIONS SERVICES IN ILLINOIS.

A. Global Time's entry into the Illinois telecommunications market will serve the public interest by creating greater competition in the intrastate interexchange telecommunications marketplace and will permit customers access to more efficient services and cost savings. Global Time's proposed intrastate services will enhance the services available to consumers and increase consumer choice through innovative, diversified and reliable service offerings. Consumers will benefit both directly, as a result of the competitively priced service options available from Global Time, and also indirectly, as Global Time's presence increases the incentives for other telecommunications providers to operate more efficiently, reduce prices, and offer more innovative services.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

EXHIBIT A

FINANCIAL STATEMENTS OF

PACIFIC GATEWAY EXCHANGE, INC.

AND ITS SUBSIDIARIES

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTAL DATA

REPORT OF INDEPENDENT ACCOUNTANTS

February 19, 1999, except for Note 10, as to which the date is March 2, 1999

To the Board of Directors and Stockholders of Pacific Gateway Exchange, Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, cash flows and changes in stockholders' equity present fairly, in all material respects, the financial position of Pacific Gateway Exchange, Inc. and subsidiaries as of December 31, 1998 and 1997 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles. In addition, in our opinion, the financial statement schedule listed in Item 14(a) of the Form 10-K presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

/s/ PricewaterhouseCoopers LLP

San Francisco, California

PACIFIC GATEWAY EXCHANGE, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands)

	December 31, 1998	December 31, 1997
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 30,041	$ 43,850
Accounts receivable, net of allowance for doubtful accounts of $4,312 in 1998 and $2,230 in 1997	87,725	62,313
Prepaids	1,244	511
Income taxes recoverable	1,358	—
Deferred income tax	2,207	1,096
Other current assets	1,408	673
Total current assets	123,983	108,443
Property and Equipment:		
Undersea fiber optic cables	34,663	31,144
Long distance communications equipment	48,710	30,535
Computers and office equipment	9,352	6,343
Leasehold improvements	2,004	702
Construction in progress	13,587	966
Cable construction in progress	12,066	883
	120,382	70,573
Less accumulated depreciation	17,335	9,140
Total property and equipment, net	103,047	61,433
Deferred income tax	78	—
Deposits and other assets	8,529	1,741
Total assets	$235,637	$171,617
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$118,303	$ 87,949
Accrued liabilities	4,193	3,733
Income taxes payable	—	1,491
Line of credit	8,700	—
Current portion of capitalized lease obligations	436	216
Other liabilities	1,304	513
Total current liabilities	132,936	93,902
Long-term portion of capitalized lease obligations	99	185
Deferred income tax	1,963	957
Total liabilities	134,998	95,044
Commitments and contingencies (Note 5).		
Stockholders' Equity:		
Preferred stock, $.0001 par value, authorized 5,000,000 shares, no shares issued	—	—
Common stock, $.0001 par value, authorized 70,000,000, issued 19,363,777, outstanding 19,220,217 shares in 1998; and issued 19,216,710, outstanding 19,073,150 shares in 1997	2	2
Additional paid in capital	65,431	60,849
Deferred compensation—restricted stock	(4,618)	(4,134)
Foreign currency translation	34	2
Retained earnings	40,190	20,254
Cost of common stock held in treasury, 143,560 shares in 1998 and 1997	(400)	(400)
Total stockholders' equity	100,639	76,573
Total liabilities and stockholders' equity	$235,637	$171,617

See accompanying Notes to Consolidated Financial Statements.

PACIFIC GATEWAY EXCHANGE, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Year Ended December 31,		
	1998	1997	1996
Revenues	$466,291	$298,609	$141,912
Revenues—related party	—	—	20,514
Total revenues	466,291	298,609	162,426
Cost of long distance services	393,640	254,076	140,340
Gross margin	72,651	44,533	22,086
Selling, general and administrative expenses	36,791	21,416	11,113
Depreciation and amortization	8,713	5,417	2,044
Total operating expenses	45,504	26,833	13,157
Operating income	27,147	17,700	8,929
Interest income	(2,292)	(2,009)	(885)
Other (income) expense, net	(1,132)	(126)	129
Income before income taxes	30,571	19,835	9,685
Provision for income taxes	10,635	7,338	3,877
Net income	$ 19,936	$ 12,497	$ 5,808
Net income per share—basic	$ 1.05	$ 0.66	$ 0.36
Net income per share—diluted	$ 0.97	$ 0.64	$ 0.34
Weighted average number of common shares outstanding—basic	19,071	18,960	16,234
Weighted average number of common shares outstanding—diluted	20,495	19,497	16,872

See accompanying Notes to Consolidated Financial Statements.

PACIFIC GATEWAY EXCHANGE, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Year Ended December 31,		
	1998	1997	1996
Operating Activities:			
Net income	$ 19,936	$ 12,497	$ 5,808
Adjustments to net income:			
Depreciation and amortization	8,713	5,417	2,044
Loss on sale of stock	—	—	129
Stock compensation expense	674	146	85
Bad debt provision	2,146	2,173	855
Equity in earnings of affiliated companies	(1,499)	—	—
Changes in operating assets and liabilities:			
Accounts receivable	(27,558)	(38,681)	(13,421)
Accounts receivable, related party	—	3,066	196
Notes and advances receivable	—	—	175
Prepaid expenses	(733)	306	(729)
Deferred tax asset	(1,189)	88	(816)
Deposits and other assets	(1,830)	(1,430)	(107)
Accounts payable	30,322	48,309	17,053
Accrued liabilities	460	2,429	532
Federal income taxes recoverable	(834)	—	—
Federal income taxes payable	(1,491)	(462)	1,758
Other liabilities	791	150	(152)
Deferred tax liability	1,006	249	488
Net cash provided by operating activities	28,914	34,257	13,898
Investing Activities:			
Purchase of property and equipment	(49,611)	(36,725)	(18,669)
Investment in subsidiaries and affiliates	(3,314)	222	—
Other investing activities	—	—	274
Net cash used in investing activities	(52,925)	(36,503)	(18,395)
Financing Activities:			
Borrowings on revolving lines of credit	8,700	—	6,200
Repayments on revolving lines of credit	—	—	(11,620)
Repayments on capital lease obligations	(498)	(209)	—
Proceeds from issuance of common stock	1,157	742	55,130
Payment of issuance costs	(57)	—	(1,042)
Payment to acquire treasury stock	—	—	(400)
Dividends received from affiliated company	900	—	—
Net cash provided by financing activities	10,202	533	48,268
Net (decrease) increase in cash and cash equivalents	(13,809)	(1,713)	43,771
Cash and cash equivalents at beginning of the period	43,850	45,563	1,792
Cash and cash equivalents at end of the period	$ 30,041	$ 43,850	$ 45,563
Supplementary Information:			
Interest paid during period	$ —	$ —	$ 276
Income taxes paid during period	$ 12,067	$ 7,841	$ 2,447

See accompanying Notes to Consolidated Financial Statements.

PACIFIC GATEWAY EXCHANGE, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(in thousands)

	Common Stock		Additional Paid-in Capital	Deferred Compensation—Restricted Stock	Foreign Currency Translation	Retained Earnings	Treasury Stock		Total
	Shares	Amount					Shares	Amount	
Balance December 31, 1995	14,100	$ 1	$ 941	$ —	$ —	$ 1,949	—	$ —	$ 2,891
Repurchase of common stock	—	—	—	—	—	—	(144)	(400)	(400)
Issuance of common stock, net of $1,042 issuance costs	4,940	1	54,087	—	—	—	—	—	54,088
Stock compensation expense	—	—	85	—	—	—	—	—	85
Net income	—	—	—	—	—	5,808	—	—	5,808
Balance December 31, 1996	19,040	2	55,113	—	—	7,757	(144)	(400)	62,472
Stock options exercised	102	—	742	—	—	—	—	—	742
Stock compensation expense	—	—	146	—	—	—	—	—	146
Tax effect of stock options exercised	—	—	714	—	—	—	—	—	714
Issuance of restricted stock	75	—	4,134	(4,134)	—	—	—	—	—
Foreign currency translation	—	—	—	—	2	—	—	—	2
Net income	—	—	—	—	—	12,497	—	—	12,497
Balance December 31, 1997	19,217	2	60,849	(4,134)	2	20,254	(144)	(400)	76,573
Stock options exercised	89	—	1,100	—	—	—	—	—	1,100
Stock compensation expense	—	—	194	480	—	—	—	—	674
Tax effect of stock options exercised	—	—	524	—	—	—	—	—	524
Issuance of restricted stock	25	—	964	(964)	—	—	—	—	—
Issuance of common stock, for investment in company	33	—	1,800	—	—	—	—	—	1,800
Foreign currency translation	—	—	—	—	32	—	—	—	32
Net income	—	—	—	—	—	19,936	—	—	19,936
Balance December 31, 1998	19,364	$ 2	$65,431	$ (4,618)	$ 34	$40,190	(144)	$(400)	$100,639

See accompanying Notes to Consolidated Financial Statements.

PACIFIC GATEWAY EXCHANGE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) The Company and Significant Accounting Policies

Description of Business and Organization:

Pacific Gateway Exchange, Inc. ("Pacific Gateway" or the "Company"), a Delaware corporation, owns and operates an international switched and domestic switched telecommunications network. The operations of Pacific Gateway have grown significantly as the result of entering into additional operating agreements with foreign partners and marketing to certain long distance companies in the United States which do not have their own international network. In addition, the Company provides international long distance services to certain ethnic retail markets, principally the Filipino-American and Japanese-American communities.

The Company is subject to various risks in connection with the operation of its business. These risks include, but are not limited to, changes in government regulation, dependence on transmission facilities-based carriers and suppliers, price competition and competition from larger industry participants.

Principles of Consolidation:

Consolidated Financial Statements include the accounts of Pacific Gateway and majority-owned and controlled subsidiaries principally in Bermuda, the United Kingdom, Russia, New Zealand, Australia, Japan and Cyprus. Investments in 20% to 50%-owned companies and partnerships are accounted for on the equity method. Intercompany transactions have been eliminated.

Foreign Currency Translation:

Assets and liabilities of operations outside the United States, for which the functional currency is not U.S. dollars, are translated into U.S. dollars using the exchange rate in effect at each period end. Revenues and expenses are translated at the average exchange rate prevailing during the period. The effects of foreign currency translation adjustments arising from differences in exchange rates from period to period are deferred and included as a component of "Stockholders' Equity".

For operations in highly-inflationary economies, principally in Russia, assets and liabilities are maintained in the reporting currency, U.S. dollars.

The effects of foreign currency transactions, and of remeasuring the financial position and results of operations in the functional currency, are included in "Selling, general and administrative expenses."

Estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the dates of the financial statements and reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates.

Cash and Cash Equivalents:

Cash equivalents consist primarily of money market accounts and called bonds with original maturities of three months or less. The carrying amounts reported in the accompanying balance sheets approximate fair market value.

Property and Equipment:

Property and equipment are stated at cost. Maintenance and repairs are expensed as incurred. Replacements and betterments are capitalized. Costs incurred in connection with the construction of new property and equipment are capitalized until the property and equipment becomes operational. The cost and related accumulated depreciation of assets sold or retired are removed from the account balance, and any resulting gain or loss is reflected in results of operations. Depreciation is provided for financial reporting purposes using the straight-line method over the following estimated useful lives:

Undersea fiber optic cables	20 years
Long distance communications equipment	5-7 years
Computers and office equipment	4-7 years
Leasehold improvements	term of lease

The Company invests in undersea fiber optic cable systems through the purchase of indefeasible rights of user ("IRU's") or through an ownership interest in cable construction consortia.

Long-Lived Assets:

Statement of Financial Accounting Standards ("SFAS") No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of,* requires that long-lived assets and certain intangible assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If undiscounted expected future cash flows are less than the carrying value of the assets, an impairment loss is to be recognized based on the fair value of the assets. No impairment losses have been recognized to date.

Income Taxes:

The Company accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes.* SFAS No. 109 has as its basic objective the recognition of current and deferred income tax assets and liabilities based upon all events that have been recognized in the financial statements as measured by the provisions of the enacted tax laws.

Valuation allowances are established when necessary to reduce deferred tax assets to the estimated amount to be realized. Income tax expense represents the tax payable for the current period and the change during the period in the deferred tax assets and liabilities.

Revenue Recognition:

Revenues for telecommunications services provided to customers are recognized as services are rendered. Revenues for return traffic received according to the terms of the Company's operating agreements with its foreign partners are recognized as revenue as the return traffic is received.

Accounting for International Long Distance Traffic:

The Company has entered into operating agreements with 44 telecommunications carriers in 28 countries under which international long distance traffic is both delivered and received. Under these agreements, the foreign carriers are contractually obligated to adhere to the policy of the Federal Communications Commission (the "FCC"), whereby traffic from the foreign country is routed to international carriers, such as the Company, in the same proportion as traffic carried into the country. Mutually exchanged traffic between the Company and foreign carriers is settled through a formal settlement policy that generally extends over a six-month period at an agreed upon rate. The Company records the amount due to the foreign partner as an expense in the period the traffic is delivered. Of the 44 agreements the Company had at December 31, 1998, 18 agreements provided that the Company generally must wait up to six months before it actually receives the proportional return traffic. In circumstances where the Company does not receive the return traffic due from the foreign partner at the end of the agreed-upon delayed return period, the Company and the foreign partner may agree to a settlement which compensates the Company for the return traffic not received, through greater return traffic in future periods, or a reduction to the Company's current accounts payable balance.

Fair Value of Financial Instruments:

The fair value of financial instruments, consisting of investments in cash, cash equivalents, receivables, accounts payable and a line of credit, is based on interest rates available to the Company and comparisons to quoted prices. At December 31, 1998 and 1997, the fair value of these financial instruments approximates carrying value.

Concentration of Credit Risk:

Financial instruments that potentially subject the Company to concentration of credit risk consist of cash and cash equivalents and accounts receivable. At December 31, 1998 and 1997, the Company had bank deposits in excess of federally insured limits of $22,891,000 and $43,650,000, respectively. The Company's customer base includes domestic and international companies in the telecommunications industry. The Company performs ongoing credit evaluations of its customers but generally does not require collateral to support customer receivables. The Company's allowance for doubtful accounts is based on current market conditions. Losses on uncollectible accounts have consistently been within management's expectations.

Earnings Per Share:

The Company adopted SFAS No. 128, Earnings Per Share, effective December 31, 1997. In accordance with SFAS No. 128, basic earnings per share is calculated by dividing net income by the weighted-average number of shares outstanding for the period. Diluted earnings per share is calculated by dividing net income by the weighted average number of shares outstanding during the period plus the dilutive effect of stock options determined using the treasury stock method.

There were no adjustments to net income in the calculation of basic and diluted earnings per share for the years ended December 31, 1998, 1997 and 1996, respectively. The reconciliation of the weighted average shares outstanding used in calculating basic and diluted earnings per share is as follows:

	Income (Numerator)	Shares (Denominator)	Per-Share Amount
	(in thousands, except per share amounts)		
1998			
Basic EPS:			
Income available to common stockholders	$19,936	19,071	$1.05
Effect of dilutive stock options		1,424	
Diluted EPS	$19,936	20,495	$0.97
1997			
Basic EPS:			
Income available to common stockholders	$12,497	18,960	$0.66
Effect of dilutive stock options		537	
Diluted EPS	$12,497	19,497	$0.64
1996			
Basic EPS:			
Income available to common stockholders	$ 5,808	16,234	$0.36
Effect of dilutive stock options		638	
Diluted EPS	$ 5,808	16,872	$0.34

Comprehensive Income:

In June 1997, the FASB issued SFAS No. 130, *Reporting Comprehensive Income*. SFAS No. 130 establishes standards for reporting and display of comprehensive income and its components in a financial statement that is displayed with the same prominence as other financial statements. Comprehensive income includes all changes in equity (net assets) during a period from non-owner sources. This includes net income and other comprehensive income. Examples of items to be included in other comprehensive income, which are excluded from net income, include foreign currency translation adjustments. The Company adopted SFAS No. 130 for the year ended December 31, 1998. Total other comprehensive income consisted of foreign currency translation gains, which were not material for all years presented.

Financial Statement Classifications:

Certain prior-year amounts have been reclassified to conform to the 1998 financial statement presentation. Such reclassifications have no effect on net income as previously reported.

(2) Income Taxes

The provision for income taxes is comprised of the following:

	Year Ended December 31,		
	1998	1997	1996
	(in thousands)		
Current tax expense:			
Federal	$ 7,318	$5,737	$3,364
State and local	1,664	986	841
Foreign	1,835	279	—
Total current	$10,817	$7,002	$4,205
Deferred tax expense:			
Federal	$ (242)	$ 265	$ (262)
State and local	(146)	71	(66)
Foreign	206	—	—
Total deferred	$ (182)	$ 336	$ (328)
Total provision	$10,635	$7,338	$3,877

Undistributed earnings intended to be reinvested indefinitely in operations outside the United States were approximately $15,349,000.

The provision for income taxes differs from the amount computed by applying the statutory federal income tax rates as follows:

	Year Ended December 31,		
	1998	1997	1996
Expected statutory amount	35.0 %	35.0 %	34.0 %
State income taxes, net of federal benefit	3.2 %	3.8 %	5.3 %
Tax exempt interest	— %	(0.5)%	(0.4)%
Undistributed earnings of certain subsidiaries	(5.0)%	(2.5)%	— %
Other	1.6 %	1.2 %	1.1 %
	34.8 %	37.0 %	40.0 %

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and amounts used for income tax purposes and the impact of available net operating loss carryforwards.

The tax effects of significant temporary differences, which comprise the deferred tax assets and liabilities, are as follows:

	December 31,	
	1998	1997
	(in thousands)	
Deferred tax assets:		
Allowance for doubtful accounts	$1,483	$ 697
State taxes	581	316
Accrued compensation	139	83
Other	276	—
Total gross deferred tax assets	$2,479	$1,096
Deferred liabilities:		
Depreciation	$2,029	$ 870
Other	128	87
Total gross deferred tax liabilities	$2,157	$ 957
Net deferred tax assets	$ 322	$ 139

(3) Acquisitions and Investments

In 1997, the Company acquired a controlling interest in Rustelnet, a provider of enhanced telecommunications services to the Russian market. The acquisition was accounted for by the purchase method, and accordingly, the results of operations of the acquired business have been included in the accompanying consolidated financial statements from the date of acquisition. The price was $36,000 with Rustelnet having cash balances of $257,000 at the time. The fair value of net liabilities acquired in the acquisition was $158,000. The excess of purchase price over the estimated fair market value of $627,000 has been allocated to goodwill. Goodwill is being amortized on a straight-line basis over a 10-year period. In connection with the acquisition of Rustelnet, the Company purchased Rustelnet shares from individual shareholders who are members of Pacific Gateway's management. A total of 690 Rustelnet shares were sold by management to the Company for $13,000.

In 1997, the Company and Globe Telecom, a company operating in the Philippines, formed a joint venture, PinTouch Telecom, to market long distance services to the Filipino-American community. In accordance with the joint venture agreement, the Company receives 47.5% of PinTouch's net earnings, for which the Company has recognized equity in earnings of $1,665,000 and $131,000 for the years ended December 31, 1998 and 1997, respectively.

In February 1998, the Company purchased 16.6% of the common stock of Ekonom S.A. de C.V., a Mexican multimedia company, for $3,300,000 in cash and $1,800,000 in the Company's common stock. The Company's investment in Ekonom is accounted for under the cost method.

(4) Segment Data

The Company adopted SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information effective January 1, 1998. SFAS No. 131 requires the disclosure of a Company's operating segments, which is defined as a segment whose operating results are distinguishable and regularly reviewed by the Company's decision makers.

Prior to the adoption of SFAS No. 131, the Company classified all operations under one segment, Telecommunications. By utilizing a combination of factors, principally services provided and geographic areas, the Company has identified three operating segments: U.S. wholesale, offshore and value-added services. The operating results of these segments are regularly reviewed by the Company's management and are integral to their decision-making process.

U.S. wholesale provides international telecommunications services to its target base of U.S.-based carriers that originate international traffic but do not have operating agreements with foreign carriers to terminate the traffic. U.S. wholesale also provides service to customers who are existing international carriers, terminating their overflow telecommunications traffic or on routes with smaller traffic volumes.

The offshore segment consists primarily of the operating subsidiaries in the UK, New Zealand, Russia and Japan. The Company has established telecommunications switching facilities in each location and provides services similar to U.S. wholesale to its country-specific customers.

The Company's third segment includes a variety of emerging and value-added services. Presently, this operating segment primarily provides international long distance services to certain ethnic retail markets, principally the Filipino-American and Japanese-American communities.

The results of operations for the Company's operating segments for each of the three years ended December 31, 1998 are as follows:

	U.S. Wholesale	Offshore	Value-Added	Total Operating Segments
		(in thousands)		
1998				
Sales to unaffiliated customers	$ 390,619	$ 55,714	$ 19,958	$ 466,291
Sales and transfers between segments	36,405	19,879	—	56,284
Total sales	$ 427,024	$ 75,593	$ 19,958	$ 522,575
Depreciation and amortization	$ 7,031	$ 1,682	$ —	$ 8,713
Operating income	$ 16,730	$ 6,677	$ 3,740	$ 27,147
Total assets	$ 151,491	$ 34,831	$ 5,857	$ 192,179
1997				
Sales to unaffiliated customers	$ 279,750	$ 17,739	$ 1,120	$ 298,609
Sales and transfers between segments	13,186	12,005	—	25,191
Total sales	$ 292,936	$ 29,744	$ 1,120	$ 323,800
Depreciation and amortization	$ 4,632	$ 785	$ —	$ 5,417
Operating income	$ 16,398	$ 1,219	$ 83	$ 17,700
Total assets	$ 105,057	$ 18,542	$ 1,071	$ 124,670
1996				
Sales to unaffiliated customers	$ 162,426	$ —	$ —	$ 162,426
Depreciation and amortization	$ 2,044	$ —	$ —	$ 2,044
Operating income	$ 8,929	$ —	$ —	$ 8,929
Total assets	$ 55,847	$ —	$ —	$ 55,847

The reconciliations from the Company's operating segments to the consolidated totals on the Company's balance sheets and statements of operations for each of the three years ended December 31, 1998 are as follows:

	(in thousands)
1998	
Total sales for operating segments	$ 522,575
Elimination of sales between segments	(56,284)
Total consolidated sales	$ 466,291
Total assets for operating segments	$ 192,179
Assets not allocated to operating segments	43,458
Total consolidated assets	$ 235,637
1997	
Total sales for operating segments	$ 323,800
Elimination of sales between segments	(25,191)
Total consolidated sales	$ 298,609
Total assets for operating segments	$ 124,670
Assets not allocated to operating segments	46,947
Total consolidated assets	$ 171,617
1996	
Total sales for operating segments	$ 162,426
Elimination of sales between segments	—
Total consolidated sales	$ 162,426
Total assets for operating segments	$ 55,847
Assets not allocated to operating segments	47,969
Total consolidated assets	$ 103,816

The Company sells to long distance international telecommunications companies, foreign partners and to retail customers. At December 31, 1998, the Company had 44 operating agreements with foreign partners and approximately 163 worldwide customers excluding U.S. retail customers. Total revenues from external customers including U.S. retail customers by country for each of the three years ended December 31, 1998 were as follows:

	Year Ended December 31,		
	1998	1997	1996
		(in thousands)	
United States	$334,746	$216,286	$116,735
United Kingdom	51,378	21,625	4,245
Russia	11,877	6,733	5,630
Australia	10,988	6,377	8,771
New Zealand	7,681	2,222	1,767
Japan	5,369	4,678	5,518
Other	44,252	40,688	19,760
Total revenues	$466,291	$298,609	$162,426

Revenues are attributed to countries based on the location of customer. Other includes revenues from customers located in countries that individually represented less than 2% of total revenues.

For the year ended December 31, 1998, there were no major customers that comprised ten percent or more of the Company's revenues. For the year ended December 31, 1997, 10.4% of the Company's revenues were derived from Frontier Communications, Inc. of $30,996,000. Matrix Telecom, Inc. derived 12.6% of the Company's revenues for the year ended December 31, 1996 with revenues of $20,514,000.

(5) Commitments and Contingencies

Litigation

The Company is not currently subject to any legal proceedings that management believes will have a material impact on the Company's financial position or results of operations.

Leases

The Company leases office space and equipment under noncancelable operating leases. Rental expenses for 1998, 1997 and 1996 were approximately $1,274,000, $965,000 and $255,000, respectively. The Company leases certain computer equipment under an agreement that is classified as a capital lease. The lease has a term of three years with a minimum purchase price at the end of the lease. Leased capital assets included in property and equipment at December 31, 1998 were $1,241,000.

Future minimum lease payments under noncancelable operating and capital leases as of December 31, 1998 are as follows:

	Operating leases	Capital leases
	(in thousands)	
1999	$ 812	$436
2000	742	112
2001	702	—
2002	672	—
2003	582	—
Thereafter	1,355	—
Total minimum lease payments	$4,865	$548
Amount representing interest		13
Present value of net minimum payments		$535
Current portion		$436

Employment Agreements

The Company has entered into employment agreements with certain employees that provide that, in the event of a change in control, each of these employees would be entitled to severance following their resignation from the Company. Should such an event occur, the Company's aggregate obligation for severance would be approximately $4,764,000. Upon any such change in control, each of these individuals would also receive full vesting of any outstanding stock options.

Commitments

At December 31, 1998, the Company had outstanding commitments of $159 million for the acquisition of additional ownership in digital undersea fiber optic cables and network equipment. This includes the commitment to purchase undersea fiber optic cable in the Japan-U.S. cable network for $86 million and in TAT-14 cable system for $70 million.

Line of Credit

During October 1998, the Company entered into an uncollateralized 1-year revolving line of credit of up to $30 million with an interest rate of LIBOR plus 1.125% with Bank of America, NT&SA and NationsBanc Montgomery LLC. As of December 31, 1998, the Company had $8.7 million outstanding and $21.3 million available under this line of credit with an interest rate of 7.75%. The line of credit, which expires December 17, 1999, has financial covenants, which require a maximum ratio of debt to annualized operating cash flow of 3 to 1 and a minimum interest coverage ratio (ratio of operating cash flow to net interest expense) of 2.5 to 1. The Company was in compliance with these covenants at December 31, 1998.

(6) Employee Benefit Plans

In September 1995, the Company established an Employee Stock Purchase Plan (the "Purchase Plan") which is intended to qualify under section 423 of the Internal Revenue Code. The Purchase Plan was not active for the years ended December 31, 1998, 1997 or 1996. Under the Purchase Plan, the Company reserved up to 400,000 shares of common stock for purchase by employees who meet certain eligibility requirements. Eligible employees may contribute up to 10% of their compensation to the Purchase Plan to purchase shares at 85% of the fair market value of the stock on the first or last day of each six-month offering period as defined in the Purchase Plan.

In 1996, the Company adopted a 401(k) plan pursuant to which eligible employees may accumulate savings on a tax-deferred basis. Each year the Company may make a discretionary profit sharing contribution to the 401(k) plan which will be allocated to the accounts of eligible employees who are employed on the last day of the year. The profit sharing allocation is made on a pro rata basis in proportion to the compensation of the eligible employees. The Company did not make a contribution in 1998, 1997 or 1996.

(7) Stock Option Plan

On September 30, 1995, the Company adopted the 1995 Stock Option Plan (the "1995 Plan"). The 1995 Plan provides for the granting of nonqualified and incentive stock options to purchase up to 1,200,000 shares of common stock. Options granted under the 1995 Plan generally vest over four years. The maximum term of options granted is ten years. The Company granted options to purchase 883,411 shares of common stock under the 1995 Plan.

On February 17, 1997, the Company adopted the 1997 Long-Term Incentive Plan (the "1997 Plan"), replacing the 1995 Plan. The 1997 Plan provides for the granting of awards of nonqualified and incentive stock options, stock appreciation rights, stock grants or stock-based performance units. Awards may be made under the 1997 Plan with respect to 4,000,000 shares of common stock and with respect to stock option and stock appreciation right awards, no more than 500,000 shares may be awarded to any one individual in any one-year period. The remaining terms of the 1997 Plan are similar to those described in the 1995 Plan.

On September 18, 1998, the Company repriced 768,500 options to purchase the Company's common stock granted under the 1997 plan to $27.688 per share, the fair market value of the Company's common stock on September 18, 1998.

SFAS No. 123, *Accounting for Stock-Based Compensation*, encourages adoption of a fair value-based method for valuing the cost of stock-based compensation. However, it allows companies to continue to use the intrinsic value method prescribed under Accounting Principles Board Opinion ("APB") No. 25, *Accounting for Stock Options Issued to Employees*, for options granted to employees and disclose pro forma net income and earnings per share in accordance with SFAS No. 123. Had compensation cost for the Company's stock-based compensation plans been determined consistent with SFAS No. 123, the Company's net income and earnings per share would have been as follows:

	Year Ended December 31,		
	1998	1997	1996
	(in thousands, except per share amounts)		
Net income—as reported	$19,936	$12,497	$5,808
Net income—pro forma	$14,308	$11,469	$5,244
Earnings per share—basic as reported	$ 1.05	$ 0.66	$ 0.36
Earnings per share—basic pro forma	$ 0.75	$ 0.60	$ 0.32
Earnings per share—diluted as reported	$ 0.97	$ 0.64	$ 0.34
Earnings per share—diluted pro forma	$ 0.70	$ 0.59	$ 0.31

The fair value of the options granted by the Company is estimated at $56.5 million on the date of the grant using the Black-Scholes Model for those options issued after the Company's initial public offering and the Minimum Value methodology for those options granted prior to the offering. The assumptions used in the Black-Scholes model are as follows:

	Year Ended December 31,		
	1998	1997	1996
Dividend yield	0.0%	0.0%	0.0%
Volatility	49.4%	40.9%	30.5%
Risk-free interest rate	4.5%	5.8%	6.7%
Assumed forfeiture rate	0.0%	0.0%	0.0%
Expected life	5 years	5 years	5 years

SFAS No. 123 requires that stock-based compensation granted to non-employees be accounted for based on the fair value-based method described above. It also requires that restricted stock granted to employees be recognized as compensation expense over the vesting period, measured at the fair market value on the grant date. In 1998 and 1997, the Company granted 25,000 and 75,000 shares, respectively, of restricted stock under the 1997 Plan. The Company recorded deferred compensation of approximately $963,000 and $4,134,000 for the years ended December 31, 1998 and 1997, respectively. This amount was recorded as a reduction of stockholders' equity and is being amortized as an expense to operations over the applicable vesting periods. For the years ended December 31, 1998, 1997 and 1996, $674,000, $146,000 and $85,000, respectively, was recognized as compensation expense for restricted stock and stock options granted to non-employees.

Stock Option Awards were:

	Year Ended December 31,					
	1998		1997		1996	
	Option Shares	Weighted-Average Exercise Price	Option Shares	Weighted-Average Exercise Price	Option Shares	Weighted-Average Exercise Price
Options outstanding, beginning of year	2,296,065	$32.14	883,411	$ 9.77	509,170	$ 8.23
Options granted	2,608,800	32.50	1,610,000	41.60	374,241	12.58
Options exercised	(88,887)	13.02	(101,660)	7.30	—	—
Options forfeited/cancelled	(824,907)	39.12	(95,686)	11.08	—	—
Options outstanding, end of year	3,991,071	$31.36	2,296,065	$32.14	883,411	$ 9.77
Option price range at end of year	$ 8.500 to $53.125		$ 8.500 to $50.188		$ 4.400 to $29.500	
Option shares available for grant at end of year	621,107		2,405,000		316,589	

The following table summarizes information concerning currently outstanding and exercisable options:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$ 8.500-$14.000	566,146	0.98	$ 9.21	411,120	$ 9.08
$24.750-$29.500	2,149,925	3.32	27.87	235,750	27.60
$38.500-$53.125	1,275,000	3.38	47.08	186,250	46.54
$ 8.500-$53.125	3,991,071	3.01	$31.36	833,120	$22.69

(8) Capital Stock

On July 19, 1996, the Company completed an initial public offering of 6,057,050 shares of common stock of which 4,940,050 were offered by the Company and 1,116,550 shares were offered by certain selling shareholders. The net proceeds to the Company (after deducting underwriting discounts and estimated offering expenses) from the sale of the shares were approximately $54.1 million.

(9) Stockholders' Rights Plan

On November 17, 1997, the Board of Directors of the Company declared a dividend of one preferred share purchase right (a "Right") for each outstanding share of Common Stock. Subject to certain exceptions, each Right, when exercisable, entitles the registered holder to purchase from the Company one one-thousandth of a share of Series A Junior Participating Preferred Stock, par value $0.0001 per share (the "Preferred Stock"), of the Company at a price of $200, subject to adjustment (the "Purchase Price").

The Rights generally will only be exercisable (i) ten days following a public announcement that a person or group of affiliated or associated persons (an "Acquiring Person") has acquired, or obtained the right to acquire, 15% or more of the outstanding shares of the Company's Common Stock or (ii) 15 business days following commencement of (or an announcement of an intention to make) a tender or exchange offer for 15% or more of the outstanding shares of the Common Stock. The Rights will expire, if not previously exercised, exchanged or redeemed, on December 1, 2007.

If any person or group generally acquires 15% or more of the Company's outstanding Common Stock, each Right, except those held by such an Acquiring Person, would entitle each holder of a Right to acquire, upon exercise at the then current exercise price of the Right, Common Stock having a value equal to two times the exercise price of the Right.

At anytime after a person or group generally acquires more than 15% of the outstanding Common Stock and prior to their acquisition of 50% or more of the outstanding Common Stock, each Right, except those held by such an Acquiring Person, may be exchanged by the Board of Directors for one share of Common Stock.

If the Company is acquired in a merger or other business combination transaction or 50% or more of the Company's assets or earnings power is sold, each Right will entitle the holder thereof (except for the Acquiring Person) to receive, upon exercise at the then current exercise price of the Right, common stock of the acquiring or surviving company having a value equal to two times the exercise price of the Right.

At any time prior to the time an Acquiring Person becomes such, the Board of Directors may redeem the Rights in whole, but not in part, at a price of $.01 per Right (the "Redemption Price").

(10) Subsequent Event

On March 2, 1999, the Company signed a commitment letter for a $200 million senior secured credit facility with Salomon Brothers Holding Company, Inc. and Goldman Sachs Credit Partners L.P. The facility may be increased in the future of up to $100 million if additional commitments are received from lenders. The completion of the financing is subject to the execution of definitive loan documents and customary conditions for this type of facility. The Company plans to use the facility to finance its undersea fiber optic cable investments and its expansion into the U.S. and Western Europe domestic markets.